

Q. TRANSFeree LIABILITY

by
Peter Bros and Terry Hallihan

1. Introduction

The Service's Exempt Organizations field audit function deals primarily with examinations that determine whether an organization's activities are in furtherance of its exempt purposes. However, EO Agents do have responsibility for unrelated business income tax, excise taxes under Chapter 42, and employment taxes. While EO examinations do not normally involve organizations or individuals attempting to avoid payment of tax obligations by transferring assets to third parties to the extent that individual or corporate examinations do, EO Agents nonetheless should be aware of the possibility of such attempts, the types of transactions that normally result when such attempts are made, and the resources that are available should the occasion to assert transferee liability arise. The overriding lesson to be learned in any discussion of transferee liability is that an agent asserting it is doing so against an entity that is not under examination. As a result, District Counsel concurrence is always required in advance. IRM 5640 covers Transferee Liability and Fraudulent Conveyances.

2. Basic Principles

In order to protect the Government's interest in collecting taxes, a Federal tax lien attaches to a taxpayer's property or rights to property as soon as a tax has been assessed, a notice and demand for tax has been made, and payment in full has not been made within a specified time. A taxpayer might be taken unawares by the notice of the tax lien and scramble to get rid of assets upon which the Government can execute the lien. If the taxpayer creates an alter ego and that alter ego transfers assets, transferee liability may arise with respect to the recipient of the assets.

Unusually astute taxpayers might see the notice of tax lien coming, however, and might attempt to transfer assets after the liability has accrued but before the notice of assessed tax is sent. This second class of actions that gives rise to transferee liability is based on state fraudulent conveyance statutes.

3. Actions in Which A Federal Tax Lien Has Arisen

When property has been transferred after the Service has gone through the procedures necessary for the attachment of a lien, a tax has been assessed, a notice and demand for tax has been made and payment in full has not been made within a specified time, the lien follows the property. Note that this does not necessarily give rise to transferee liability as this is a general rule of enforceability of tax liens.

A. Creation of an Alter Ego

Alter egos are similar to the mail order ministry cases so familiar to EO personnel, but without the coloration of an exempt purpose. For instance, the taxpayer, Mr. X, has received a notice of assessed tax and has no intention of paying. He sets up a corporation and transfers all of his assets to it. The taxpayer continues to live in the transferred residence, but the corporation pays the principal, interest, taxes and insurance on the residence. In addition, the corporation pays for food, clothes, repairs on the residence, a new auto and vacations in the Caribbean for the taxpayer, his wife and children.

Under the facts, the corporation is Mr. X's alter ego. Under the alter ego doctrine, a corporate entity may be disregarded for purposes of determining ownership of property. The two basic requirements for finding that a corporation is an alter ego are (1) that the unity of interest and ownership is such that the separate personalities of the corporation and the individual no longer exist, and (2) that a fraud or inequity would result from the failure to disregard the corporate entity.

Once a corporation is found to be an alter ego of a taxpayer, the entire amount of the Federal tax lien can be asserted against the corporation.

B. Transfers of Assets to Nominees

Instead of setting up and transferring assets to an organization that cannot be distinguished from the taxpayer, a delinquent taxpayer might attempt to defeat the Federal tax lien by placing assets in another person's name. These nominee transfers of property are only simulated transfers of property. The delinquent taxpayer still maintains control of the property.

For instance, in attempting to assert a lien against the property where the delinquent taxpayer, Ms. Y, lives, an agent finds that the property is listed in her brother's name. Ms. Y's return shows that she is paying the property tax

and claiming interest deductions on a mortgage secured by the property. Further investigation shows that she also pays the utility bills.

The property is being held by the brother in name only. He is a nominee. When a nominee situation exists, the lien attaches to the specific property which is the subject of the simulated transfer. Unlike the alter ego situation, in which all of the assets of the corporation are owned by the delinquent taxpayer, nominee liens only attach to the specific property transferred. Further discussion of nominee liens is found in IRM 5355.33. Again, this does not necessarily give rise to transferee liability, but is part of the general rules of tax liens.

C. Benefits, Limitations and Drawbacks

There are a number of benefits, limitations and drawbacks to recommending nominee/transferee or alter-ego liens, as well as a number of requirements. The major drawback is that the lien is going against an entity that is not under examination. This exposes the Service to litigation such as wrongful levy actions, as well as clouding the title to the property. As a result, all proposed liens must be approved in advance by District Counsel. In addition, applicable reports must be made to District Counsel throughout the processing of the lien.

The lien is based on state law and the Uniform Commercial Conveyance Act. It puts the public on notice of the Government's claim. The lien attaches to the specific property in the nominee's name or to the property in the alter ego's name, and it can cover any type of tax since the lien is on specific property. The statute of limitations is the same as the ten year collections statute against taxpayer-transferor, and it takes precedence over the further encumbrance or transfer of the property.

4. Transfer of Property Before the Federal Tax Lien Arises

When property has been transferred after the Service has gone through the procedures necessary for the attachment of a lien, a tax has been assessed, a notice and demand for tax has been made, and payment in full has not been made within a specified time, the lien follows the property. However, if no tax lien has arisen when the transfer is made, there is no lien attached to the property when it is transferred and the Service has to demonstrate that the transferee is liable for the transferor's taxes. In general, the tax must arise before the transfer takes place. As discussed below, if the transferee liability arises by operation of law, the transferee is generally liable for the full amount of the transferor's taxes, regardless of the value of the property transferred. If transferee liability arises in equity, however, the transferee's liability is limited

to the lesser of the value of the property transferred or the amount of the transferor's liability.

A. Transferee Liability Arising By Operation of Law

The easiest way for the Service to attach a lien to transferred property is if there is transferee liability specified by law. In this case, all that is necessary is to demonstrate that the property was transferred and that the transferee is obligated to pay the liability either by statute or contract.

An example of statutory transferee liability is a state merger statute. Many of these statutes treat a successor corporation as responsible for the liabilities of the predecessor corporation. An example of contractual transferee liability is when a business or individual agrees to purchase the assets and assume the liabilities of a going concern. Since taxes are a debt, the purchasing party obligates itself for the transferor's taxes.

When transferee liability arises by law, there is no requirement to show that the transferor has been rendered insolvent by the transfer and thus could not pay the taxes involved. When transferee liability arises by operation of law, there is also no need to prove the value of the transferred assets. In fact, administrative collection actions against the transferor do not have to be exhausted.

B. Transferee Liability Arising in Equity

Transferee liability in equity is based on state fraudulent conveyance statutes. Most of these state statutes are based on the common-law principle that debtors may not transfer assets for less than adequate consideration if they are left unable to meet their obligations. Liability in equity exists if the transfer is fraudulent to creditors.

To prove actual fraud under state law requires a proof of intent. Intent is a state of mind and is not readily provable. If actual fraud can be proven, however, it is generally unnecessary to show that the transfer made the delinquent taxpayer insolvent.

Constructive fraud under state law does not require a showing of intent. To prove constructive fraud requires a showing that the transfer is not founded on good consideration and has left the delinquent taxpayer insolvent thereby impairing the rights of the creditors. The Service can establish transferee liability that arises in equity by showing five key factors: the transfer of assets was for less than full consideration; the transfer was made after the liability for

taxes accrued; the transferor is liable for the tax; all reasonable efforts have been made to collect the liability from the transferor taxpayer; and the transferor was insolvent when the transfer was made, or the transfer made the transferor insolvent.

When transferee liability arises in equity, the transferee's liability is limited to either the amount owed by the transferor or the value of the property transferred, whichever is less.

C. Protecting the Government's Interest

When transferee liability is suspected in cases where the transfer was made before the Federal tax lien attached, administrative actions under IRC 6901 should be attempted before legal action because of the costs involved in legal action and because of the uncertainty of success. However, administrative action may not be taken prior to consultation with District Counsel.

5. Example

Examination agents are accustomed to revoking organizations for private inurement, and, because the assets of the organization have been depleted, closing the case with a substitute 1120.

This strategy fails to take into consideration the benefits of the inurement, the fact that private parties may have taken excessive salaries, rental payments, and other unreasonable fees to enrich their own asset base.

In one case, an exempt organization had been carrying on gambling activities for the stated purpose of using the proceeds to carry on an exempt charitable program. However, the agent found that the controlling operator was actually converting gambling profits to his own personal use, which included purchasing real estate and acquiring "jumbo" certificates of deposit. In addition, he had accumulated a portfolio of securities.

At the time the revocation occurred, however, the operator was dead, and the exempt organization was a shell.

The agent found that the operator had left a very wealthy widow. The agent traced the assets from the exempt organization's profits to the widow and developed the revocation, substitute 1120, and the case for transferee liability.

The agent then contacted District Counsel who helped in the preparation of an assessment of transferee liability. The agent used the assessment of trans-

feree liability on the property bequeathed to the widow to obtain a closing agreement that recovered a substantial part of the property that had been obtained from the profits of the exempt organization.

While the gambling situation might well be obvious, there are many situations in which operations under the direction of a single individual could have resulted in inurement and produced a substantial buildup of personal assets over the years which are still in the possession of the private individual and could be used to pay a transferee liability assessment.